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BEFORE
THE SUBCOMMITTEE ON AVIATION
COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

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Mr. Chairman and Members of the Subcommittee, I am happy to be here today to discuss the potential significance of the financial-market phenomenon known as the leveraged buyout, or "LBO", for the nation's major airlines.

The LBO, as a tool for corporate acquisition or takeover, has become popular during the past ten years. Up to now, however, almost all of the acquisitions and mergers in the airline industry have been consummated without the use of LBOs. Airline corporate management, for the most part, has not been affected by outsider takeovers via the LBO mechanism. To be sure, TWA's "going private" in 1988 might be considered close to an LBO, but that transaction did not result in a change of ownership, and the carrier's debt leveraging was done through a bond issue the previous year.

The picture is rapidly changing. About a month ago, NWA, Inc., the parent of Northwest Airlines, announced that it had entered into a merger agreement with Wings Holdings, Inc. This transaction appears to be an LBO-type acquisition of Northwest Airlines, the nation's sixth largest carrier in terms of domestic

revenue passenger miles. Wings has begun to file data with the Department relating to the continuing fitness and citizenship of Northwest under this proposed transaction. Consistent with our established procedures in continuing fitness cases, and in view of the LBO issues raised, we have also requested additional information from Northwest about the transaction. Since the case is still under review, I cannot comment on the merits of this acquisition per se.

The Northwest buyout is almost certainly a harbinger of future LBO attempts in the airline industry. Several other airlines with strong balance sheets and conservative managements may well become targets of other LBO attempts, if they aren't targets already.

Such fundamental developments should be of concern to all of us charged with oversight of the world's greatest and safest air transportation system. At the Department of Transportation, we have been considering the basic questions raised by this phenomenon with great care, and with the advice of others, including other government agencies with special insight and expertise in the area.

There are, to start with, widely ranging opinions on both the perceived benefits and drawbacks of LBOs. For example, some observers tell us that, under most circumstances, debt leveraging can dramatically enhance competitive behavior. A leveraged

company must become more efficient and deliver the cash flow to service its increased debt and to create a profit for the owners.

Often marginal operations, unprofitable divisions, and unrelated businesses or properties are sold off or eliminated. This allows the transformed company to focus its attention on those operations in which the company has competitive advantages and strengths, making it a stronger and more aggressive competitor overall. In this connection, new owners and fresh management may improve the corporate image, service, and operating efficiency of the company. Lastly, because ownership of a company that has gone through a leveraged buyout is usually closely held, some argue that the owners may be in a better position to demand management performance and ensure that the firm's value is maximized.

There are, of course, strong views about the downside to leveraged buyouts, especially in an industry as cyclical as air transportation. Servicing a huge debt can be potentially debilitating and restrictive. If there were a series of LBO-type acquisitions resulting in a number of indebted carriers with a diminished capacity to attract new capital, acquisitions of newer, advanced aircraft might be more difficult. Moreover, these carriers might have a decreased financial capability to expand and help renovate needed airport facilities.

How likely is this scenario and to what degree might air service eventually suffer? This is the question we at the Department of Transportation are wrestling with right now.

At this point let me emphasize again that the more negative scenario is not a prediction -- and we are not at this time advocating any new legislation or regulation to address these concerns. What we are saying is that we are currently in the process of examining carefully the likely impact LBO transactions would have on the air transportation system. If and when we conclude that there is a problem, and that government remedies are indicated, you can be sure that we will pursue those remedies with determination. To the extent we felt that our existing statutory authority was deficient, we would seek Congress' help in beefing up that authority.

If these comments seem to be erring on the side of caution, it is simply because we cannot responsibly advocate government intervention in essentially private, market-driven decisions prior to the completion of our review of this complicated issue. The crux of the matter, as I said earlier, is the degree to which a heavy debt burden may impair the functioning of an air carrier and eventually of the air transportation system. On the basis of what we know today, we believe that it would be premature to conclude that the debt burden resulting from an LBO would, ipso facto, impair the ability of the airline in question to maintain fit and efficient operations. Again, because some experts believe LBOs actually increase operating efficiency, we should proceed cautiously. We do not believe that the Subcommittee should act further on legislation along the lines of S.1277 until we have answers to the fundamental questions.

We recommend caution with a confidence that derives from the effectiveness of our existing authority. Congress has already provided the Department the wherewithal to review the fitness of air carriers, and we intend to use that authority aggressively to examine the likely effects of LBOs on individual airlines. The fitness review procedures set forth in section 401 of the Federal Aviation Act serve both as a means of looking at prospective applicants -- aspiring new entrants -- and as a means of assuring the continuing fitness of incumbent carriers. The latter procedure is directly relevant to circumstances in which a carrier undergoes substantial changes in its ownership and financial position.

As you may be aware, we have three separate elements in our fitness review process -- management competence, financial condition, and compliance disposition. We also review the citizenship of the carrier. These procedures enable us to scrutinize carefully a given LBO transaction to determine whether it is likely to be detrimental to the carrier and, as a consequence, damaging to the airline industry in general.

We can require a fitness review in connection with any transaction that will result in a significant change in a carrier's operations, management, or financial condition. This, of course, includes any large-scale sale of slots, gates, aircraft, or international routes. Secretary Skinner has made clear his

determination that the Department will play an active role in the disposition of "governmentally bestowed" authorities such as international routes.

Finally, we have one additional tool which should not be overlooked. We can recommend that the Department of Justice, under its Hart-Scott-Rodino review authority, block, on antitrust grounds, any asset sale or airline acquisition that involves another air carrier, if we believe that the result would be anticompetitive.

Let me add that the DOT staff is currently working on a comprehensive study of competition in the airline industry. We expect that the study will be completed by mid-October, and along with our current in-progress review of the impact of LBOs, we believe that we will then have a better perspective on the LBO situation. If necessary, we will be far better prepared to fashion an informed and reasonable response to the effects LBOs may present. In the interim, however, we feel that the tools currently available are adequate to deal with the circumstances presented by potential LBO acquisitions.

Mr. Chairman, you and the Subcommittee are to be congratulated for recognizing so quickly the importance of exploring the potential effects of LBOs on the airline industry. There can be no question but that the LBO phenomenon could have potentially serious

consequences for the airline industry. You may be sure that the Department of Transportation is examining that phenomenon very closely, and that we will be more than happy to work with the Subcommittee as our inquiry proceeds.

Mr. Chairman and Members of the Subcommittee, that concludes my prepared statement. Thank you for your time and attention. As always, it is a great privilege to be able to appear before you and to discuss these vitally important issues. I will be happy to answer any questions that you may have.